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Supreme Court of the United States

OCTOBER TERM, 1944.

No. 137

PRUDENCE REALIZATION CORPORATION,
Petitioner,

—against—

JOSEPH W. FERRIS, GEORGE L. LONG and HENRY LEIFERT as Trustees under a Declaration of Trust dated as of July 1st, 1938, with respect to 307 West 36th Street (Burnside) First Mortgage Participation Certificates, CITY BANK FARMERS TRUST COMPANY and MARTIN S. LINDGROVE as Trustees under the Last Will and Testament of HERMAN STUTZER, deceased, on behalf of themselves and other holders of certificates in 307 West 36th Street (Burnside) First Mortgage Participation Certificates, SOLOMON ZAUDERER, MILTON KIMMELMAN, IRVING ZAUDERER and CHARLES KIMMELMAN, doing business as KIMMELMAN AND ZAUDERER, on behalf of themselves and all other holders of Prudence Bonds Corporation participating certificate issue, and HUNTER L. DELATOUR, RAYMOND REISLER and JEROME THRALLS, Trustees of Realty Associates Securities Corporation, Debtor, holders of Burnside Certificates,
Respondents.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK, COUNTY OF NEW YORK.

BRIEF ON BEHALF OF RESPONDENTS, CITY BANK FARMERS TRUST COMPANY AND ANOTHER, AS TRUSTEES, ETC.

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EUGENE BLANC, JR.,
Counsel for City Bank Farmers Trust Company and Martin S. Lindgrove, as Trustees, etc., Respondents.

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OPINIONS BELOW.

The opinion of the Supreme Court, New York County, Additional Special Term, appears at R. 221, 222, but is not officially reported. The opinion of the Appellate Division, First Department, appears at R. 231-233, and is reported in 266 App. Div. 543. The opinion of the Court of Appeals of the State of New York appears at R. 241-251, and is reported in 292 N. Y. 210.

STATEMENT.

The facts were presented by the pleadings (R. 171-219), affidavits (R. 9-142), the deposition of one witness (R. 142-171), and a stipulation of facts (R. 219-221). On petitioner's motion and respondents' cross-motions for summary judgment the lower court held that an issue of fact was presented and denied all motions. On appeal, all parties agreed that no factual issue existed and that all the evidentiary facts were contained in the record. The Appellate Division granted the motion of the present petitioner, holding that its certificates were entitled to parity of treatment with all others, and affirmed the denial of the cross-motions of the present respondents. The Court of Appeals of the State of New York reversed, and granted the cross-motions of the present respondents for summary judgment holding that the certificates held by the petitioner were subordinate.

The facts so presented are as follows:

A.

The Creation of the Certificate Issue.

On June 25, 1927, The Prudence Company, Inc., was the owner of a bond and mortgage in the sum of $1,200,000, made by Burnside Improvement Co., Inc. The bond and mortgage were assigned without consideration by said The Prudence

Company, Inc., to its wholly controlled affiliate, Prudence-Bonds Corporation, pursuant to a scheme whereby Prudence-Bonds Corporation was to issue certificates participating in the bond and mortgage. The holders of such certificates thereby became tenants in common of the bond and mortgage (R. 13). As part of this arrangement, Prudence-Bonds Corporation further assigned the bond and mortgage to The Bank of America, as depositary under a deposit agreement entered into between them at the same time (Ex. A, R. 18-32). The Prudence Company, Inc., then executed an instrument of guaranty, whereby it guaranteed to the owners and holders of the certificates to be issued, the payment of interest on the certificates when due, and the payment of the principal thereof, when due, or within eighteen months thereafter (Ex. C, R. 36-39). Certificates were issued according to the arrangement to various persons, and are now outstanding to the extent of $1,016,000. Of these, $431,212.86 were reacquired, as hereinafter stated, by the guarantor, and are now held by its successor, petitioner Prudence Realization Corporation.

The form of the certificate is shown at Exhibit B, R. 32-35. This is the issue referred to as the "Burnside Issue". The mortgage and the certificates matured by their terms on July 1, 1932 and were not paid (R. 147). The owner had also previously defaulted in paying an installment of principal due in January of 1932.

B.

The Financial Condition of the Guarantor at the time of the Reacquisition by it of the Certificates.

Since one of the arguments in this brief will be that the defaulting guarantor reacquired its certificates under such circumstances that it must be concluded that the reacquisitions were made in connection with its guarantee obligation and as a method of reducing that obligation *pro tanto*, (in direct contrast to the circumstances in *Prudence Realization*

Corporation v. *Geist*) it is necessary to review briefly the financial background against which such reacquisitions must be projected.

As already stated, the Burnside mortgage and certificates matured by their terms on July 1, 1932 and were not paid. The guarantor had a grace period of eighteen months with respect to principal payments only. During the year preceding this maturity, to wit: 1931, the cash position of the guarantor had deteriorated tremendously. Its cash balance as at June 30th, 1931, had been nearly $3,500,000; as at December 31, 1931, it was only $783,738.08. Its other assets as at the same date consisted of marketable securities amounting to only $168,045.25 and note and accounts receivable amounting to $1,563,459.63. The balance of its assets were either pledged assets, or the guarantor's own securities, or those of affiliated companies. (Stipulation, par. 1, R. 219.)

On the other hand, the guarantor was faced during the year 1932 with maturities of mortgage securities guaranteed by it, aggregating $22,791,433, which was an increase of $21,816,333 over the comparatively small total of maturities of $875,100 for the year 1931. Clearly, in view of the increasing defaults by mortgagors, its assets were insufficient to pay these increasing maturities. The pyramiding of its maturities is dramatically shown by the table of maturities of obligations guaranteed by The Prudence Company, Inc., for the eleven years from 1927 to 1937, as follows:

1927	$ 100
1928	1,000
1929	2,600
1930	2,400
1931	875,100
1932	22,791,433
1933	32,488,177
1934	40,162,715
1935	26,230,120
1936	16,096,161
1937	10,676,186

From these figures emerges the inexorable fact that the collapse of the whole structure was inevitable, since the mortgages themselves were admittedly not worth their face amounts. The directors were not blind to this and moved in three directions to stave off the obvious end for as long as possible.

First, in November of 1931, they commenced negotiations for a loan of $25,000,000 from the Reconstruction Finance Corporation. (Stipulation, par. 1, R. 219.) This loan was granted to the extent of $20,000,000 in February of 1932 (R. 154). The guarantor's Assistant Treasurer testified that this loan was necessary "for us to keep on as a going concern" (R. 155). The statements of the Company in its application for this loan are also of the utmost significance. The guarantor stated that $12,000,000 of the amount asked for would be used to "renew maturing mortgages", since the mortgages, if foreclosed, would not bring in enough to pay off the loan:

> "* * * **If we fail to renew selected maturing mortgages which we have guaranteed, the flood of foreclosure actions will necessarily result * * * in loss to investors in first mortgage securities, since their properties when foreclosed will bring only a fraction of the amount originally conservatively loaned thereon.**"

As a second step the guarantor took advantage of the eighteen months grace clause in its guaranty. On January 1, 1932, it notified the holders of the certificates that it had suspended principal payments (R. 145). At the same time, the owner of the premises subject to the Burnside Certificates defaulted in the payment of an installment of principal due in January, 1932, so that the mortgage was technically in default from that time on, although the default could not be then enforced against the guarantor because of the grace clause. On June 13, 1932 the guarantor caused title to the mortgaged premises to be taken by its wholly owned subsidiary, Amalgamated Properties, Inc., which later executed an assignment of rents to the guarantor (R. 159).

The third step taken by the guarantor was to attempt to reduce or postpone its guaranty liabilities by acquiring Burnside Certificates at a discount or exchanging Burnside Certificates for other certificates of later maturities. This proc[illegible] began on March 3rd, 1932, and continued until January 2[illegible]4, 1933 by which time the guarantor had repurchased or re-acquired Burnside Certificates, aggregating $431,212.86 in principal amount (R. 124; Ex. D, R. 40-44). The method used in acquiring certificates will be discussed in detail later, but it should be noted that prior to January 1, 1932, the guarantor had not owned any of the Burnside Certificates (Stipulation, par. 6, R. 220).

On March 4, 1933, the guarantor was taken over by the Superintendent of Banks of the State of New York. In 1935, the debacle so clearly foreseen by the Company occurred and it filed its petition in the Bankruptcy Court, asking for its reorganization under Section 77-B. The United States District Court for the Eastern District of New York approved the petition on February 1, 1935, appointed Trustees, and later adjudicated the guarantor to be insolvent (R. 16).

C.

The Reorganization Proceedings.

Two separate and distinct reorganization proceedings are referred to herein and in the discussion, it is necessary to keep them apart to avoid the confusion which is caused by the failure of petitioner's brief to make this distinction. The reorganization directly involved is that of the Burnside certificate issue. The one which is only indirectly involved is that of the guarantor, The Prudence Company, Inc. These two reorganization proceedings were not consolidated, and in this respect, this case differs from *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, in which the Court stated at page 92:

> "The present proceeding was begun by respondent's petition in the *consolidated* reorganization of Prudence Company and Amalgamated Properties in the Eastern District of New York * * *."

The factual situation here with respect to these separate proceedings is set forth in paragraph 4 of the stipulation herein (R. 220), which reads as follows:

> "4: The proceedings for the reorganization of Amalgamated Properties, Inc., under Section 77B of the Bankruptcy Act, were never consolidated with the above mentioned proceedings for the reorganization of The Prudence Company, Inc., but the petition for the reorganization of Amalgamated Properties, Inc. as a subsidiary of The Prudence Company, Inc. was filed in the proceedings for the reorganization of The Prudence Company, Inc., and on April 22, 1938, an order was made by the United States District Court, for the Eastern District of New York, severing the proceedings for the reorganization of Amalgamated Properties, Inc. from the proceedings for the reorganization of The Prudence Company, Inc."

The opinion of the Court of Appeals in this case clearly differentiates between the two reorganizations (R. 241-242).

1. The reorganization of the Burnside certificate issue.

We are primarily concerned with the reorganization of the Burnside issue in the proceedings filed by Amalgamated Properties, Inc., a wholly owned subsidiary of the guarantor, used by it for the purpose of taking title to the properties, subject to the defaulted mortgages in which certificates had been issued. In this way Amalgamated Properties, Inc., obtained title to the property subject to the Burnside issue of certificates, and numerous others.

On March 16, 1936, Amalgamated Properties, Inc., filed a petition for its reorganization in the United States District Court for the Eastern District of New York as a part of the then pending reorganization of the guarantor, under the

procedure then permitted by Section 77-B of the Bankruptcy Act (R. 125). Later, however, the Amalgamated Properties proceeding was severed from the reorganization proceeding of the guarantor and the two proceedings thereafter were conducted independently of each other (Stipulation, par. 4; R. 220). As already mentioned this is different from *Prudence Realization Corporation* v. *Geist*.

In this reorganization, a separate plan was proposed for each certificate issue (R. 125-126). In accordance with this practice, a separate plan was proposed for the Burnside issue and was ultimately confirmed (R. 93-122). This plan provided, in substance, that the mortgage in which the certificates participated was to be assigned to trustees and then extended and modified. Such assignment was made and respondents are now such trustees with all rights of an owner of the mortgage (R. 100). The property subject to the mortgage was also to be conveyed to these same trustees without a merger of the mortgage and the fee (R. 97). The certificates were modified to conform to the plan (R. 102), and the rights of the holders thereof were changed from those of tenants in common of the mortgage to those of beneficiaries of a trust. Section 1, Part VI, of the Plan (R. 102) provides that all holders of certificates shall assign to the trustees, their rights and interests as owners of shares in the mortgage and shall receive, "in lieu thereof, rights as beneficiaries of the trust of said certificated bond and mortgage in accordance with the provision of this Plan, and said certificates shall thenceforth evidence the extent of their interests as such beneficiaries".

The guarantor, through its 77-B Trustees, filed a claim in the Amalgamated proceeding based on the Burnside certificates acquired by it as aforesaid. The point was raised that the guarantor, having defaulted, was not entitled to participate in the mortgage on a parity with the other holders of certificates whose claims it had guaranteed and not paid. It was provided in the Burnside plan that this question should be reserved for future determination and that no interest should be paid on the Burnside certificates re-acquired by the guarantor.

> "* * * unless and until it shall have been finally adjudicated by a Court of competent jurisdiction whether or not The Prudence Company, Inc., or its Trustees or their successors or assigns are entitled to receive such cash, or other property, or securities and to share in the proceeds of the property to be assigned to the Trustee pursuant to the Plan, and on a parity with other Certificate-holders or otherwise" (R. 121).

Pending such adjudication, the trustees are to hold in escrow the interest otherwise payable on the so-called "Prudence-owned Certificates" (R. 120-121).

Beyond that, the Plan itself also provided for the treatment to be accorded to the certificates in the event of subordination, which treatment is much more favorable to the guarantor than that which would follow as a matter of law. If the adjudication is to the effect that such certificates are subordinate, then one-half of the interest otherwise payable thereon is to be paid into a sinking fund for the retirement of certificates, and the other half is to be distributed as additional interest on the publicly-held certificates (R. 121-122).

Thus the reservations were obviously inserted not solely to expedite the closing of the case, as claimed by petitioner (petitioner's brief, pp. 2, 6) but in order to give the guarantor a more favorable position in the event of subordination, in return for its consent to such subordination in advance even if subordination should constitute the guarantor a separate class of creditors.

These provisions of the plan constitute as a matter of agreement a complete disposition of the money allocable to the guarantor's certificates and are entirely different from the simple reservation in the *Geist* case which was inserted by the Judge in the order confirming the plan and was not a part of the bargain embodied in the plan. Moreover, as will later appear, the latter was only a reservation of bankruptcy jurisdiction to try a bankruptcy question then pending before the bankruptcy court, not, as is the Burnside reservation, a complete saving of the status quo coupled with a termination of bankruptcy jurisdiction.

The Burnside plan contained two other reservations. These were an express reservation of all rights of action against the guarantor (R. 97), and the following in Part IX, paragraph 5 (R. 106):

> "* * * the certificate-holders hereby expressly reserve any and all rights which they may have against said guarantor or guarantors by reason of any breach of any such guaranty or guaranties."

The plan of reorganization for the Burnside certificate issue was duly accepted in writing by the 77-B Trustees of the guarantor in the manner prescribed by the Bankruptcy Act (Stipulation, par. 3, R. 220). Thus, the guarantor expressly became a party to the agreement and accepted its benefits in lieu of its distributive rights under the bankruptcy law. Petitioner, Prudence Realization Corporation, is merely the successor of the guarantor, being, in effect, no more than a transferee of the assets at a bankruptcy sale.

The Burnside plan was duly confirmed and consummated and is now in effect (R. 93-122).

The reorganization proceeding has been terminated by appropriate final order and none of the present parties is or ever has been in bankruptcy (R. 130-131).

As stated, we are only secondarily concerned with any reorganization other than that of the Burnside issue. Yet, since petitioner's brief has involved the guarantor's reorganization, that proceeding must be clearly defined, if only to show its relative unimportance.

2. The reorganization of the guarantor.

After the guarantor was declared insolvent, a plan of reorganization was approved by the District Court, the effect of which was to transfer to petitioner all its assets for liquidation (R. 16). The liquidation however, was to take place outside the bankruptcy court and apart from, and after the termination of, bankruptcy jurisdiction. Actual distribution was to be made neither in bankruptcy nor according to the

bankruptcy rule, but by petitioner as a New York corporation under the terms of an agreement with the creditors, *i.e.* the reorganization plan.

Among the assets so transferred to petitioner were the Burnside certificates aggregating $431,212.86 in principal amount. Holders of certificates and other guaranteed securities filed claims in that proceeding, based on the guaranty. Petitioner's predecessor, however, filed no claim in this proceeding. (Stipulation, par. 5, R. 220.) Such guaranty claims were unsecured claims in bankruptcy *simpliciter* and hence were required to be allowed to the full extent thereof. (See *Ivanhoe Building & Loan Association v. Orr*, 295 U. S. 243.) The plan itself however, changed this and treated them as claims secured by "Collateral" (R. 49). It provided for their reduction by the "New Loan Value" of the mortgaged property underlying the certificates to which the guaranty attached (R. 51-52, 59-60). The "New Loan Value" of such property or "Collateral" was to be fixed according to a formula in the plan (R. 66-69).

The actual distribution of the amounts realized on the assets of the bankrupt (after their transfer to petitioner) was thus not to be made to creditors in accordance with the Bankruptcy Law, but outside of bankruptcy and in accordance with an agreement incorporated in the plan itself, which agreement treated the guaranty holders as secured creditors (R. 59-61), and approximated the method adopted in reorganizations of mortgage and guaranty companies in the Courts of New York. Neither the plan nor the order confirming it attempted to fix or adjudicate the value of the assets so transferred, among which were the Burnside certificates acquired by the guarantor as aforesaid. The plan, however, recognized specifically that the question of the parity of these certificates had been raised and that if it were decided adversely to the guarantor, the value of the Burnside certificates as an asset of the bankrupt would be less. It accordingly provided that if there should be

> "uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist; * * *" (R. 60).

The reference to the "Debtor" in the foregoing quotation means the guarantor, The Prudence Company, Inc., and the reference to the "New Company" means the present petitioner.

The plan also recognized that many of the certificate holders had dealt, or would deal, with their certificates and the underlying mortgages in separate reorganizations thereof. It was feared that such dealings might affect their rights to participate in the plan, and in order to prevent such a result and to anticipate the argument that such dealings might constitute a waiver of claims, such as the claim to subordinate the guarantor's certificates, the certificate-holders required the inclusion in the guarantor's plan of a provision that unless a guaranty claim should have been expressly withdrawn, released, compromised or expunged,

> "* * * no action taken subsequent to February 1, 1935, by or on behalf of any holder of a guarantee claim against the Debtor with respect to his Collateral shall bar any such claimant from participating in the benefits of the Plan to the extent herein provided" (R. 66).

The reference to "Collateral" means the mortgage underlying the certificate issue, and it will be recalled that February 1, 1935 is the date of the approval of the guarantor's petition for reorganization in bankruptcy.

The District Court's order confirming the guarantor's plan of reorganization further recognized that equities in favor of third persons might exist, and accordingly when it directed the transfer of the assets to petitioner it provided as follows (R. 82):

> "The Section 77-B Trustee of the Debtor is hereby further directed to transfer to the New Company forthwith, subject to all then existing equities and rights of third parties therein, all assets held by said Section 77-B Trustee for the account of others or held by said Section 77-B Trustee in any agency or other segregated account, pending settlement or determination of equities or rights asserted by others. * * *"

This proceeding has also been terminated by an appropriate final order, and petitioner is functioning as an independent New York corporation, which has never been in bankruptcy.

SUMMARY OF ARGUMENT.

POINT I. No bankruptcy or other Federal question is presented.

POINT II. Petitioner's certificates were subordinated by the terms of a contract construed in accordance with the state law as laid down by its highest court.

POINT III. Relative rights in the local real estate and in the mortgage thereon created by local law were preserved by the reservations in the reorganization plans.

POINT IV. Prudence Realization Corporation v. Geist does not require a different result since the reservations were entirely different.

POINT V. Opinion of the New York Court of Appeals follows the view above outlined and does not result in either lack of uniformity or improper preference.

POINT VI. In any event Prudence Realization Corporation v. Geist requires subordination of the certificates acquired by the defaulting guarantor under the circumstances of the present case.

POINT VII. The State Court properly decided a question of local law and its judgment should be affirmed.

ARGUMENT.

POINT I.

NO BANKRUPTCY OR OTHER FEDERAL QUESTION IS PRESENTED.

None of the parties to the present proceeding is or ever has been in bankruptcy or in reorganization under the Bankruptcy Act. The trusts of the New York real estate under which the respondents Ferris, et al., hold the real property and the mortgage thereon were created by virtue of a reorganization plan, but the proceeding in which such plan is adopted has been finally closed by an appropriate order and all bankruptcy jurisdiction has finally terminated.

Petitioner argues (p. 7 of its brief) that such closing was solely for the purposes of an agreement between Amalgamated and a creditor, but the true reason would seem to be that the job of the reorganization court was finished and the necessity for bankruptcy jurisdiction had ceased. Nevertheless, the proceeding was completely closed, as petitioner says, for all purposes, even if this operates, as respondents claim, against petitioner's present purposes.

All the elements involved in the reorganization have therefore weighed anchor, cast off their ties to the bankruptcy, and started out afresh without any further connection with the bankruptcy court. The charter which dictates the course thereafter to be followed is the plan of reorganization, which is an agreement among the creditors made binding upon dissenters, if any, by the order of confirmation. The question presented is one of the construction of this agreement and of contracts which are its subject matter. This is not a bankruptcy question. It is clearly a question of local law.

Erie Railroad Co. v. *Tompkins*, 304 U. S. 64, 78;
Ruhlin v. *New York Life Insurance Co.*, 304 U. S. 202-205.

The requirement of equality of distribution applies only to bankruptcy *simpliciter*. It does not apply to distributions made under a plan of reorganization, where the only requirement is that the *plan* shall be fair and equitable. The court has found that the Burnside plan is fair and equitable, and that finding may not now be collaterally attacked when no question of bankruptcy distribution is involved.

Petitioner's argument in its broadest aspects (see especially p. 14, first paragraph, of petitioner's brief) would mean that any question ever arising under a plan of reorganization, or affecting reorganized property, would have to be determined by reference to the bankruptcy law and bankruptcy standards, even after a complete termination of the bankruptcy proceeding and the end of bankruptcy jurisdiction. In another aspect, and as a consequence of its argument, petitioner's interpretation of this Court's decision in *Prudence Realization Corporation* v. *Geist* would mean that the question of subordination has been forever foreclosed, and that there are no circumstances under which there could be subordination against a bankrupt guarantor. Such, we submit, is not the law, but is, on the contrary, the *reductio ad absurdum* of petitioner's argument.

POINT II.

PETITIONER'S CERTIFICATES WERE SUBORDINATED BY THE TERMS OF A CONTRACT CONSTRUED IN ACCORDANCE WITH THE STATE LAW AS LAID DOWN BY ITS HIGHEST COURT.

The subject matter of the present proceeding is local real estate, interests therein, and liens thereon, which is by both tradition and authority the proper concern of local courts. The real estate against which the liens are asserted by the petitioner, and whose priority is disputed by the respondents, is physically situated within New York. The mortgage on this real estate and the participating interests therein were created in New York, and exist by virtue of its local law.

The trust interests, into which the mortgage interests were transmuted by the reorganization plan, exist only by virtue of the New York statute (N. Y. Real Property Law § 96), and the trustees respondents are accountable only to the Supreme Court of the State of New York. The purpose of this proceeding is to determine the relative rights in New York real estate (or the proceeds thereof) held for the satisfaction of a New York mortgage.

All the events upon which the New York courts rely to work a subordination had transpired prior to the bankruptcy, which occurred on February 1, 1935:

1. The execution of the guaranty and the depositary agreement, and the issue of certificates took place in 1925;

2. The default in the payment of an installment of principal due on the mortgage underlying the certificates occurred in January, 1932;

3. The invocation by the guarantor of the eighteen months' grace clause with respect to principal payments took place on January 1, 1932;

4. Both the certificates and the underlying mortgage matured on July 1, 1932, and were not paid;

5. The guarantor reacquired the defaulted securities during the period from March 3rd, 1932 to January 23, 1933; and

6. The eighteen months grace clause expired on July 1, 1933 and neither the mortgage nor the certificates were paid.

Thus, long before the Bankruptcy Act could apply, or bankruptcy or any other Federal jurisdiction attach, a whole congeries of rights and liabilities had come into existence among the guarantor, the certificate holders in the Burnside issue, certificate holders in other issues, and other creditors of the guarantor. These relations and the interpretation of the contracts giving rise to them, were necessarily governed

by state law. No other law was applicable, and they could not be ascertained or defined by reference to any other system of law except that of New York State. The reacquired certificates had become, if subordinated, in effect a second lien on the mortgaged property. Had this proceeding or some other appropriate proceeding been instituted at that time, whether in the state court, or in a Federal court by virtue of diversity jurisdiction, subordination would have been decreed. The decisions of the New York Court of Appeals are clear.

Matter of Lawyers Title & Guaranty Co., 287 N. Y. 264;
Matter of People, 285 N. Y. 337;
Pink v. *Thomas*, 282 N. Y. 10;
Matter of Title & Mortgage Guaranty Co., 275 N. Y. 347;
Title Guarantee & Trust Co. v. *Mortgage Commission*, 273 N. Y. 415;
Matter of Lawyers Mortgage Co., 272 N. Y. 554;
Matter of N. Y. Title & Mortgage Co., 272 N. Y. 556.

These decisions have established a rule of law with such definiteness and finality as to constitute it a local rule of property, action or conduct which the Federal courts will recognize and enforce.

Petitioner, moreover, does not contend in this Court that the reacquired certificates are not subordinate as a matter of local law. Indeed, that question is not now before this Court or within the petitioner's assignment of errors. Petitioner's contention is that something has occurred in the bankruptcy proceedings which, despite *Erie Railroad Co.* v. *Tompkins*, 304 U. S. 64, *Wichita Royalty Co.* v. *City National Bank, et al.*, 306 U. S. 103, 107, and *Moore* v. *Illinois Central Railroad Co.*, 312 U. S. 630, 633, requires that this Court ignore the local real estate rules and substitute a concept applicable, at best, only to bankruptcy *simpliciter*, as distinguished from corporate reorganization in the bankruptcy court.

Since corporate reorganization in the bankruptcy court is a process of preservation or adjustment, by mutual agreement, of rights created under the local law, a plan may properly provide for the preservation of a status or for the adjudication at some future date, of existing relative rights and liabilities, and as we shall show in the next point, this is exactly what the Burnside plan of reorganization did.

POINT III.

THE RELATIVE RIGHTS IN THE LOCAL REAL ESTATE AND IN THE MORTGAGE THEREON CREATED BY LOCAL LAW WERE PRESERVED BY THE RESERVATIONS IN THE REORGANIZATION PLAN.

The Burnside plan, as already stated, contained three reservations. The first was a reservation of all rights of action against the guarantor (R. 97), the second was a reservation by the certificate holders of "any and all rights which they may have against said guarantor or guarantors by reason of any breach of such guaranty or guaranties" (R. 106), and the third and most important was a reservation of the entire question of parity contained in the amendment to the plan (R. 120-122). Although petitioner argues to the contrary, the fact is that this latter reservation is entirely different from the reservation in the *Geist* case. As heretofore stated, this reservation included a complete agreement as to the disposition of the moneys allocable to the certificates repurchased by the defaulting guarantor, and obtained for the guarantor a treatment more favorable than would have been accorded to the guarantor had the certificates been subordinated in bankruptcy *simpliciter*, as distinguished from corporate reorganization in the bankruptcy court. Petitioner's brief has stated in several places, *e.g.*, pages 2, 6 and 18, that the reservation was inserted solely to avoid delay in consummating the plan. This statement has no support in the record, and may at best be treated only as argument of counsel, but as such argument it is completely erroneous,

for it is clear that from the point of view of the guarantor, the reservation was inserted so as to enable the guarantor to obtain this better treatment in the event of subordination. From the point of view of the certificate holders, subordination might have caused the holders of the subordinated certificates to become a separate class of creditors whose separate consent to the plan would have been needed. By the reservation inserted as part of the bargain incorporated in the plan, and approved by the District Court, the guarantor consented in advance to a possible subordination, thus avoiding for the certificate holders the difficulty of obtaining its consent as a separate class in return for their granting to the guarantor a more favorable treatment for its subordinated certificates.

To the extent that the guarantor's plan of reorganization may be important, it is to be noted that closely correlated with these reservations in the Burnside plan were the two reservations in the guarantor's plan of reorganization, to wit, the establishment of a reserve on the assumption that parity did not exist in the event that the question were raised with respect to any particular issue (R. 60), and the reservation (R. 66) that no action taken by the holder of a guaranty claim in dealing with the mortgage and real property underlying his certificate should affect his right to participate in the guarantor's plan.

Finally, the order directing the transfer of assets from the guarantor to the present petitioner specifically provided that those assets were to be transferred subject to all "existing equities and rights of third parties". (Order of confirmation, par. 20, R. 82.)

Petitioner is therefore no more than a transferee of such assets at a bankruptcy sale, and hence can acquire no greater rights than the bankrupt had.

Smith v. *Chase National Bank of the City of New York*, 84 F. (2d) 608;

In re Moose River Lumber Co., 251 Fed. 409;

Matter of Lawyers Title & Guaranty Co., 287 N. Y. 264, 273 (*supra*).

It is to be noted that the reservation of the question of parity in the Burnside plan extended expressly to "The Prudence Company, Inc., or its trustees or their successors or assigns" (R. 121), and hence is binding upon the petitioner, which is a successor or assign.

Nothing in either of the bankruptcy reorganization proceedings purported to adjudicate either the value or the priority of lien of the reacquired certificates or the relative rights and priorities between the certificate holders and the guarantor. Those reacquired certificates were a claimed asset of the guarantor, and petitioner, as the guarantor's successor, is clearly entitled to realize upon them for whatever they may be worth. Having acquired them, however, subject to the agreement in the Burnside plan, whereby a more favorable treatment was accorded to it in return for its concession to consent in advance in the event of subordination, it may not now argue that subordination is not permitted by virtue of the plan itself. The reservations must mean that the court of competent jurisdiction is to determine the relations existing between the guarantor on the one hand and other certificate holders on the other hand, as they existed either immediately prior to, or regardless of the bankruptcy and unaffected and unaltered thereby. Unless this be true, the reservations mean nothing at all, or, as the Court of Appeals said, the Burnside plan must be modified. In other words, it was recognized in arriving at the bargain which constitutes the reorganization plan, that prior to the bankruptcy, the certificate holders stood in a certain relation to the guarantor, and the guarantor's reacquired certificates had a certain standing as to priority of lien. All this could have been adjudicated prior to the bankruptcy as a matter of state law, or it might have been adjudicated during the course of the bankruptcy in the state courts by permission or direction of the bankruptcy court.

Thompson v. *Magnolia Petroleum Co.*, 309 U. S. 478, 483.

Hence, one of the reservations in the guarantor's plan significantly chose February 1, 1935, the date of the approval of the petition. Clearly, the intent and the effect of the reservations in the Burnside plan were to carry the entire set of relations through the bankruptcy proceedings intact, so that they emerged from the bankruptcy after the final orders in exactly the same condition as when they entered, with each party able to make the same claims that would have been possible without the bankruptcy but with neither party able to make a stronger claim, merely by reason of the bankruptcy.

With respect to these relations, the period of the bankruptcy was an episode which left them unaffected, so that when the reorganized enterprise was launched anew, with no ties to the bankruptcy court, it necessarily resumed its course upon and was governed by the current of the state decisions.

Any other interpretation of the reservations will render a large portion of the plans nugatory and, despite the agreements contained in the plan, despite the consent of the guarantor, and despite the approval of the plan by the District Court, will give to petitioner as successor to the defaulting guarantor a much higher position than the guarantor itself occupied.

POINT IV.

PRUDENCE REALIZATION CORPORATION v. GEIST DOES NOT REQUIRE A DIFFERENT RESULT, SINCE THE RESERVATIONS WERE ENTIRELY DIFFERENT.

Petitioner's counsel has stated, at the bottom of page 7 of its brief, that the parity question "had been reserved in the Zo-Gale Plan" which was involved in the *Geist* case. The record will show that this is not accurate and that the reservation was not contained in the plan but solely in the order confirming the plan. Petitioner tends to correct this statement at page 11 of its brief, but the tabular comparison contained at pages 16-17 of the brief is again inaccurate in

that it fails to include the complete bargain that was made in the Burnside case. This difference between the two reservations is of the utmost significance.

The bargain arrived at in the Zo-Gale Plan, on its face, gave parity to the guarantor. The bargain in the Burnside plan did not—on the contrary, it specifically contemplated a possible subordination and provided for the results that would follow. At the time of the confirmation of the Zo-Gale Plan, Geist, the Trustee, felt that the plan had left open the question of the effect of the bankruptcy on the right of the guarantor to share. Accordingly, he applied to the bankruptcy court in the bankruptcy proceeding (which was considered by this Court a consolidated proceeding of Prudence and Amalgamated [316 U. S., at p. 92]), for an order fixing the distributive rights of the claimants in bankruptcy. The Court, wishing to confirm the plan and yet retain its exclusive jurisdiction to determine that bankruptcy question, inserted the reservation *of jurisdiction* in its order of confirmation, and the same reservation *of jurisdiction* is found in the final order closing the Amalgamated reorganization as a whole. Thus, in the *Geist* case, there was no bargain as to the effect of subordination, the reservation was not a reservation *of status* or of relative positions as a part of the plan, and had not been bargained for by the certificate holders as a part of the consideration for their consents thereto. The reservation was a reservation of bankruptcy jurisdiction contained solely in the order confirming the plan after the consents had been filed, and there could be therefore no provisions such as are found in the Burnside plan for the treatment of the certificates after the adjudication of the reserved question, which differed as a matter of agreement from the bankruptcy rule of distribution. The question presented in the *Geist* case was the strictly legal one of the rights to which the guarantor was entitled as a matter of bankruptcy distribution in the consolidated bankruptcies of Prudence and Amalgamated. Exclusive jurisdiction to determine that question was reserved by the bankruptcy court itself, in its own order for determination by it, in, and as

part of, the bankruptcy proceeding then pending before it. Distribution was ultimately to be made not in accordance with any agreement but "in accordance with the final adjudication of such court" (R. 127). Thus, in deciding the question of bankruptcy distribution in the bankruptcy court, the bankruptcy rule necessarily applied.

The question in the present case, however, is, by force of different reservations, one of substantive rights, for the reservation in the Burnside plan was not a reservation of bankruptcy jurisdiction—that jurisdiction was completely terminated without qualification by the final order closing the case—but it was a reservation for the purpose of preserving unaffected by the bankruptcy, a status, a group of relations, which existed independently of the bankruptcy and were governed solely by state law, and it was coupled with a complete termination of bankruptcy jurisdiction.

Accordingly, petitioner is not correct in the assumption on page 17 of its brief that the only two factual variations between the *Geist* case and the present case are the selection of the Federal forum in the former and the state tribunal in the latter, and the continuation of the proceeding in the one case and its termination in the other. The difference lies in the very substance and nature of the reservation itself.

POINT V.

THE OPINION OF THE NEW YORK COURT OF APPEALS FOLLOWS THE VIEW ABOVE OUTLINED AND DOES NOT RESULT IN EITHER LACK OF UNIFORMITY OR IMPROPER PREFERENCE.

The Court of Appeals reveiwed the Burnside reorganization, noted the termination of the bankruptcy proceeding and the end of bankruptcy jurisdiction, and considered the effect of the reservations in the Burnside plan. It then correctly found that neither the plan nor any order in the proceeding purported to adjudicate or affect the relative rights and priorities in the local real estate. Petitioner's argument, at page

15 of its brief, distorts the state court's meaning when it attempts to point out that the question could not be determined "unaffected by the reorganization", because the plan changed the disposition of income to "a basis wholly inconsistent with state law". This change, so beneficial to the guarantor, was made, however, as a matter of agreement in the plan, and did not result from the operation of the bankruptcy law. Thus, the true meaning of the state court's language is clear.

Having found no agreement or order modifying the relative rights of the certificate holders and having correctly held that in a corporate reorganization rights remain unaffected unless acted upon by the plan or an order in the proceeding, the state court held that the relative rights of certificate holders had been unaffected, and in this suit for a determination thereof it was faced with the question of defining and determining those relative rights as a matter of its own substantive law.

In order to do this, the Court made an elaborate and detailed examination of all the relevant documents and the surrounding circumstances in order to ascertain the intent of the parties, as shown in the contracts which gave rise to the relations among them. It examined the instrument of guaranty, it analyzed the deposit agreement, and it considered the provisions of the certificates. These are the documents which evidence the contractual relations among the certificate holders. It considered in detail the circumstances surrounding the creation of the certificate issue and the reacquisition of the certificates by petitioner.

It then came to the conclusion that there was an actual intent clearly evidenced in these documents to grant priority to certificate holders in the event of a reacquisition by the guarantor after default. This is the "visible evidence" to which this Court referred in the *Geist* case, 316 U. S., at page 94. Whatever may have been the basis of any of the other decisions of the New York Court of Appeals in cases involving the parity question, it is clear that in this case the Court of Appeals relied directly upon a construction of the docu-

ments to find the actual intent of the parties. The conclusion was not rested upon any presumed intent or any so-called natural or special equities.

On the question of the construction of contracts, the state law is binding.

> "The subject [i.e., the construction of contracts] is now to be governed, even in the absence of state statute, by the decisions of the appropriate state court. The doctrine applies though the question of construction arises not in an action at law, but in a suit in equity."
>
> *Ruhlin* v. *New York Life Insurance Co.*, 304 U. S. 202, 205.

Petitioner, at pages 22-24 of its brief, argues the question of construction, but it must be clear that, insofar as petitioner bases its position on a claim that the state court wrongly construed the contract, the position is untenable.

Petitioner also argues that the result of following the local state rule would contravene the bankruptcy principle of uniformity, but here again petitioner confuses the issue, for if the question is one of the construction of a contract or any other proper subject matter of local concern, then the fact that different local courts arrive at different results is merely "a permissible difference of opinion in the state courts" (*Ruhlin* v. *New York Life Insurance Co.*, (*supra*) at p. 206), and is not a violation of the bankruptcy principle of uniformity.

> *Hanover National Bank* v. *Moyses*, 186 U. S. 181, 190;
>
> *Thompson* v. *Magnolia Petroleum Co.*, 309 U. S. (*supra*) at page 483;
>
> *Stellwagen* v. *Clum*, 245 U. S. 605, 613.

The reorganization court will recognize and enforce contracts among creditors providing for or resulting in, subordination.

St. Louis Union Trust Co. v. *Champion Shoe Machine Co.*, 109 F. (2d) 313 (C. C. A., 8th, 1940).

Petitioner has also argued that subordination is but a local rule of distribution in the handling of insolvent estates. Since the Court of Appeals decision was based squarely upon the construction of the contract, the argument is inapplicable in this case. Moreover, the Court of Appeals has itself destroyed any basis for such argument by pointing out that it was dealing neither with a bankruptcy nor a state liquidation proceeding, but with a suit between parties, none of whom had ever been in bankruptcy and none of whom was being liquidated, and the purpose of which was "to determine relative rights in property held for the satisfaction of a mortgage". 292 N. Y., at page 215 (R. 242).

Further, the principle that a surety may not be repaid in whole or in part until he has completely discharged his obligation to his creditors, i.e., that he may not have "partial subrogation" is firmly established in the law of New York.

Hanlon v. *Union Bank*, 247 N. Y. 389;
McGrath v. *Carnegie Trust Co.*, 221 N. Y. 92, 95.

This rule, as this Court itself recognized in the *Geist* case, is "applied by the Federal courts in liquidation proceedings under Federal statutes".

Prudence Realization Corporation v. *Geist*, 316 U. S. (*supra*) at page 96;
United States v. *National Surety Company*, 254 U. S. 73, 76;
Jenkins v. *National Surety Co.*, 277 U. S. 258;
American Surety Co. v. *Electric Co.*, 296 U. S. 133.

The rule has been applied in bankruptcy, to this very guarantor, of which the petitioner is the successor:

> "The Prudence Company that guaranteed the debt is seeking to realize upon the collateral before paying off the whole of the obligation to secure which the collateral was given. This is contrary to the established rule in cases of subrogation."
>
> *In re Prudence Bonds Corporation*, 102 F. (2d) 531, 534 (C. C. A., 2d, 1939).

Finally, petitioner has argued that a preference will be created in the event of subordination.

In dealing with this question of preference, petitioner's brief does not dispel an existing confusion, since it fails to differentiate here between the two bankruptcies. While such differentiation may not have been necessary in the *Geist* case, where this Court considered the proceeding as a consolidated proceeding of Prudence and Amalgamated, such differentiation is essential here, where the record specifically points out that there was no such consolidation and that the two proceedings were separate after the order of severance. The first point therefore is to ascertain in which proceeding a preference can be claimed. Further, it must be borne in mind that these are proceedings for corporate reorganization as distinguished from bankruptcy *simpliciter*, so that it might well be possible for a plan to recognize an existing preference in return for some other concession which would move the judge to declare, as he has in both the reorganizations referred to herein, that the plans are fair and equitable. Obviously, such a ruling cannot be collaterally attacked at this point.

As emphasized throughout this brief, we are concerned primarily only with the reorganization of the Burnside issue. Surely, it cannot be claimed that with respect to that reorganization subordination would create a preference, as argued by the petitioners at pages 28-32 of its brief, or would violate the rule of pro rata distribution of an insolvent estate. This is clear because the plan itself contemplated possible subordination and as a matter of agreement gave the guarantor a better treatment for its subordinated certificates than would otherwise have been accorded to it. This

bargain was approved by the judge in charge of the reorganization as fair and equitable. The guarantor, having specifically consented to this plan by express permission of the District Court (Stip., par. 3, R. 220), petitioner as its successor may not now be heard to say, when the possibility of subordination has become a fact, that an improper preference is being granted to one group of creditors of Amalgamated. For a court so to hold, it would have to modify the Burnside plan and overthrow the finding of fairness and equitableness.

With respect to the reorganization of the guarantor, if that is germane, it again seems difficult to see how a preference can occur. Surely, petitioner cannot mean a preference as defined in Section 60 of the Bankruptcy Act (U. S. Code, Title 11, Chap. 6, Sec. 96), since that means a transfer made by an insolvent debtor within four months of the filing of a petition. No such transfer appears. Again, the claim cannot be made that the possibility of subordination was not foreseen by the District Judge, since there was a provision in the plan of the guarantor itself providing for the setting up of reserve funds in the case of subordination, and petitioner took the assets under an order which transferred them subject to existing equities and rights of third persons. These provisions were likewise approved as fair and equitable by the District Judge, who was the same Judge as the one who approved the subordination provisions of the Burnside plan. Nor can it be argued that subordination causes unequal distributions by the petitioner, for the distributions are required by the plan to be made ratably out of the proceeds of whatever assets have been realized upon, and the guarantor never filed any claim as a creditor against itself in the proceedings for the reorganization of The Prudence Company, Inc. (Stipulation, par. 5, R. 220).

The reacquired certificates were assets of the bankrupt, to be liquidated by petitioner for whatever their value might be. If, by reason of subordination as a matter of substantive state law, their value was reduced, petitioner will realize less, but whatever the value, the asset, when liquidated, will be shared equally and ratably by all creditors of the guarantor,

without preference or priority in favor of the certificate holders in the Burnside or any other issue.

Petitioner has also urged that a preference may result from subordination because in bankruptcy the guaranty claims must be allowed in full. In state rehabilitation proceedings, it argues, the guarantee claimants are treated as secured and required to reduce their claims, so that subordination of reacquired certificates is there equitable, but such equity disappears in bankruptcy. However, the plan under which the petitioner holds title to the reacquired certificates, provides that the guaranty claims (although technically allowed in full) must be treated as secured and reduced by the value of the security. The basis of the argument is thus destroyed by the agreement reached in the Plan and although the lien position of the Burnside certificate holders is improved by subordination, their claims in the general assets of the guarantor suffer by the reduction, and this reduction operates to the general benefit, equally and ratably, of all creditors of the guarantor. Petitioner may not have the benefits of both the reduction in the claims *because* of the security, and also the full benefit of the security itself.

Even if subordination, and the results which flow from it as a matter of law, might be said to create a preference in bankruptcy *simpliciter* as distinguished from corporate reorganization in the Bankruptcy Court, such legal results have been prevented from occurring by reason of the agreement in the reorganization plan which provides otherwise. The Burnside plan provides that if there should be subordination, the money otherwise allocable to the subordinated certificates shall be divided between additional interest on non-subordinated certificates, and a sinking fund for the purchase of such certificates. Such provisions were not in the Zo-Gale plan considered in the *Geist* case, in which the results of subordination would follow strictly as a matter of law. The Burnside plan prevents these results. The operation of the sinking fund will more quickly reduce the senior lien and thus enhance the value of the subordinated certi-

ficates and at the same time reduce the participation of the Burnside certificate holders in petitioner's assets. Indeed, subordination may permit the non-subordinated certificates to be paid in full from the mortgaged property which would completely eliminate any claims on the guarantee and thus actually benefit the other creditors of petitioner. Since the guarantor accepted these beneficial provisions, petitioner, as its successor, may not urge as a reason against subordination, a preference which can be created only in their absence.

POINT VI.

IN ANY EVENT, PRUDENCE REALIZATION CORPORATION v. GEIST, REQUIRES SUBORDINATION OF THE CERTIFICATES ACQUIRED BY THE DEFAULTING GUARANTOR UNDER THE CIRCUMSTANCES OF THE PRESENT CASE.

Prudence Realization Corporation v. *Geist* held that where an "equitable basis for requiring the surety or guarantor to postpone the assertion of rights which it derives from or are incidental to his suretyship, to the rights of creditors whom he has undertaken to secure, is wanting", the guarantor may share on a parity with such creditors in distributions in bankruptcy. 316 U. S. (*supra*) at page 96. This is surely nothing new or novel, and was not treated as such by the Court. On the contrary, it was treated as perfectly consistent with the well established cases cited therein such as *United States* v. *National Surety Company*, 254 U. S. 73, and *Jenkins* v. *National Surety Company*, 277 U. S. 258, which recognized the equitable doctrine that a guarantor may not ordinarily compete with creditors whose claims it has guaranteed, in seeking distributions from the estate of the insolvent principal.

The *Geist* case allowed Prudence Realization Corporation parity with respect to an unissued or "uncertificated" part of the mortgage therein involved, amounting to $7,200, and also

with respect to reacquired certificates totalling $816.67. The Court found that the guarantor had not acquired its interests in the mortgage as an "incident" to the guarantee and its rights were not "those of a subrogee". With respect to the $7,200 unissued part of the mortgage, this was obviously and necessarily true, since the guarantor's rights were residual rights in the mortgage, acquired when it made the original mortgage loan, and even prior to its execution of the instrument of guaranty.

With respect to the $816.67 of repurchased certificates, the Court's finding was just as clearly required by the specific admission in the record before it, that the certificates were purchased as investments in the regular course of business. In the *Geist* proceeding, Prudence Realization Corporation, the guarantor's successor, alleged with respect to said repurchase as follows:

> "It was the intention in each instance upon the acquisition of the aforementioned certificates by Prudence to hold such certificates as investments, and the acquisition by Prudence was not intended at any time to constitute a cancellation or payment under its guaranty." (Record on appeal in *Prudence Realization Corporation* v. *Geist*, p. 24, fols. 71-72.)

This was specifically admitted by Geist, the Trustee, who was therein seeking subordination, as follows:

> "William T. Cowin, president of Prudence Realization Corporation, the respondent herein, formerly a trustee of the debtor, states in his affidavit that in many instances The Prudence Company, Inc. reacquired certificates theretofore sold to and held by the public, and that it was the intention of The Prudence Company, Inc., to hold such certificates in its own investment porfolio as an investment.
>
> "This deponent does not take any exception to such statement but respectfully submits that this presents an incomplete picture." (Record on appeal, *supra*, fols. 118-120.)

With respect to the Burnside Issue, the facts are entirely different. There was no "unissued" or "uncertificated" part of the mortgage. All the certificates were acquired by the guarantor as an incident to its guaranty, and in an obvious attempt to reduce or postpone its guaranty liabilities not, as claimed by petitioner, in the ordinary course of its business. The rights which petitioner is now asserting, are those of a subrogee, and hence there is a clear equitable basis for requiring the postponement of its rights under the rules laid down by the Court in *Prudence Realization Corporation* v. *Geist*.

The precarious financial condition of the guarantor immediately preceding and during the time when it was reacquiring its own defaulted securities has been described. It may be briefly recapitulated, as follows:

1. November, 1931, the guarantor seeks a $25,000,000 loan from Reconstruction Finance Corporation, admitting in its application therefor that the mortgages, if foreclosed, would not bring enough to cover its guaranty liabilities—and, by necessary implication, that the guarantor without the loan would be unable to meet them.

2. December, 1931, the guarantor's balance sheets show it to be unable to meet its maturing guaranty liabilities for the year 1932.

3. Its guaranty liabilities for 1932 are over twenty-five times as great as for 1931, and for 1933, are about $10,000,000 more again.

4. January, 1932, the Burnside mortgage is in default in the payment of an instalment of principal.

5. January, 1932, the guarantor suspends principal payments on its certificates and invokes its eighteen months' grace clause.

6. February, 1932, the Reconstruction Finance Corporation loan is granted for $20,000,000, but the guarantor does not revoke its suspension of principal payments.

7. March 3, 1932, the guarantor acquires its first Burnside certificate.

8. June, 1932, the guarantor commences heavy acquisitions of Burnside certificates.

9. July 1, 1932, the Burnside mortgage and certificates mature and are not paid.

10. January 23, 1933, the last Burnside certificate is acquired.

The guarantor acquired its first Burnside certificate on March 3, 1932, in the face amount of $1,500 (Ex. D, R. 40). Prior to this it had not owned any Burnside certificates (Stipulation, par. 6, R. 220). As maturity approached, the purchases grew heavier and in the month of June, 1932, immediately preceding maturity on July 1, 1932, the guarantor acquired certificates aggregating $23,852.75 in principal amount. The balance of the certificates aggregating $405,860.11 in principal amount were acquired after maturity, and likewise after default (R. 40-44).

The certificates were not cancelled at the time because, as the guarantor's assistant treasurer testified, they had matured, the mortgage had not been paid off, and cancellation was unnecessary (R. 149). It is not claimed that the certificates remained uncancelled because they were being retained in the portfolio as an investment. Nevertheless, on March 1, 1933, certificates aggregating $425,212.86 were cancelled and one certificate in that amount was issued to Reconstruction Finance Corporation. On April 4, 1933, this certificate was cancelled and another in the same amount was issued to The Prudence Company, Inc. (R. 44). The cancellations and reissues of the remaining certificates are shown at R. 44.

Three methods were used to acquire the certificates. The

first was the use of a secret and concealed brokerage account called the "Pender-Buckbee-Merriam" account (R. 44), which was known only by a number (R. 155). This account was used to acquire certificates at prices described as "substantially less than the par value thereof" (R. 16) and "rather substantial discounts" (R. 149). In the Burnside issue the discounts ranged from 15% to 34% (R. 44), although the guarantor advertised to its security holders that it would attempt to repurchase directly from them at discounts of only one per cent (R. 145). The "Pender-Buckbee-Merriam" account was created "within the first three months of 1932" (R. 149), or at about the same time that the guarantor invoked the eighteen months' grace clause, and shortly before the Burnside mortgages and certificates matured.

To the extent that the guarantor purchased its matured and defaulted securities at a discount, it was reducing *pro tanto* its guaranty liabilities, as distinguished from the purpose and method of acquisition of Zo Gale certificates. Hence, when it later asserts a claim based upon the certificates so acquired, it is, within this Court's language in the *Geist* case, in the position of a surety which has only partially fulfilled its obligations. Payment to it before the creditors are paid, will therefore not be permitted.

The second method of acquisition was to have the holders of matured or maturing Burnside certificates exchange them for certificates in other issues of later maturities (R. 146; Ex. D, R. 40-42). Sometimes the certificate-holder would be given part cash and a new investment for the balance. All new investments so issued were concededly of later maturities than the certificates in the Burnside issue and were not yet in default (Stipulation, par. 2, R. 220).

The purpose and effect of this practice was obviously to extend the time for the payment of the guaranty liabilities of The Prudence Company, Inc., and, therefore, any claim based on the Burnside certificates so acquired is, within this Court's language in the *Geist* case (p. 96), a claim derived from, or incident to, the guaranty, and was not acquired

independently of it. Here again the time, purpose and method of acquisition are different from those of the Zo-Gale certificates.

The third method of acquisition was the purchase of certificates directly from the holder for the minimum amount of cash which such holder could be persuaded to take (R. 146, 157-158). When the certificate-holder pressed for cash payment, his certificate "would be repurchased at five or six or seven, or sometimes even ten per cent. discount" (R. 157). Many of the certificates were purchased at "par flat" (R. 42-43), i.e. at a discount amounting to the accrued interest thereon (R. 158).

These acquisitions at a discount were for the purpose of reducing the guaranty liabilities and petitioner, as successor to the defaulting guarantor, is now improperly attempting to assert rights which are derived from partial performance of the suretyship obligation, again within the Court's language in the *Geist* case and again different from the acquisitions in that case.

It is thus precisely with respect to the existence of an equitable basis for subordination that the *Geist* case differs factually from this case. There is here a clear equitable basis for subordination in the undisputed circumstances surrounding the acquisition of the certificates by the guarantor. They show the acquisition by the guarantor of defaulted securities at substantial discounts just prior to, and after, maturity at a time when the guarantor, if not actually insolvent, had at the least, a seriously impaired capital, and was forced to borrow from the government to keep in business at all. To say that such acquisitions were "independent of the guaranty" is to fly in the face of the facts. At that time, and under those circumstances, the guarantor could have had no thought but to reduce or postpone its pyramiding guaranty liabilities. It was struggling desperately with every means at its command to prevent or delay the debâcle which finally occurred. It could not have purchased these certificates in the ordinary course of its business, as petitioner claims, or for investment purposes, because at that time its business was not running any "ordinary course", and it had no funds

available for investment in defaulted securities. It was simply engaging in salvage operations.

We submit that on the present record, every equitable consideration requires here the postponement of the rights of the defaulting guarantor. *American United Mutual Life Insurance Co. v. City of Avon Park*, 311 U. S. 138; 145-146.

Petitioner has urged, however, that the *Geist* case goes further than has been stated in this brief. Its claim is that the *Geist* case has decided once for all that there may be no subordination of certificates, and that neither this nor any other court is now free to determine whether or not there should be subordination simply because the guarantor is bankrupt. This claim amounts to saying that something mysterious has happened during the bankruptcy which forever prevents the question of subordination from being raised in this or any other case. An analysis of the *Geist* case, however, will reveal that this is not the fact.

It held that to the extent that the New York cases lay down a rule of state law governing the rights of claimants in state liquidations, they do not control in making distributions in bankruptcy (316 U. S., at p. 95). However, since the bankruptcy court is a court of equity, it must determine, with "appropriate regard for rights acquired under rules of state law", whether the conduct of a claimant in acquiring its claim is inequitable so as to require subordination to other claims which would otherwise be of the same class. Hence, the question remains whether there is, in fact, any equity which requires a defaulting guarantor to subordinate its claims (316 U. S., bottom p. 95, and top p. 96). That question must always be faced because of the basic principle that a surety may not "compete with other creditors payment of whose claims he has undertaken to assure, until they are paid in full" (316 U. S., at p. 96), and because the bankruptcy court admittedly has power to "subordinate the claims of one claimant to those of others of the same class where his conduct in acquiring or asserting his claim is contrary to established equitable principles. *See Taylor* v. *Standard Gas Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 308 U. S. 295; and *In re Bowman Hardware & Electric Co.*, 67 F. [2d] 792". (316 U. S., at p. 93.)

But this Court found on the facts of record before it, that the equitable basis for subordination was wanting because the rights acquired by the guarantor in that case were acquired independently of the guaranty and were not those of a subrogee acquired as an incident of the suretyship (316 U. S., *supra*, at p. 96).

Then the Court inquired whether a basis for subordination could be justified on the theory of avoiding circuity of action, despite the lack of such equities, and pointed out (p. 97 of the opinion) that this basis is available only in the case of a solvent guarantor and is not *alone* a valid reason if the guarantor is insolvent. Despite assertions to the contrary by petitioner, the insolvency of the guarantor has no other significance. This was clearly recognized by the United States Circuit Court of Appeals for the Second Circuit in a case involving a similar guaranty by this very same bankrupt guarantor.

> *In re Prudence-Bonds Corporation* (*supra*), 102 F. (2d) 531, 534 (C. C. A., 2nd, 1939).

Thus, this Court, in complete harmony with the *Geist* case, may here subordinate the reacquired certificates, as every consideration of justice and equity requires.

POINT VII.

THE STATE COURT PROPERLY DECIDED A QUESTION OF LOCAL LAW AND ITS JUDGMENT SHOULD BE AFFIRMED.

Respectfully submitted,

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